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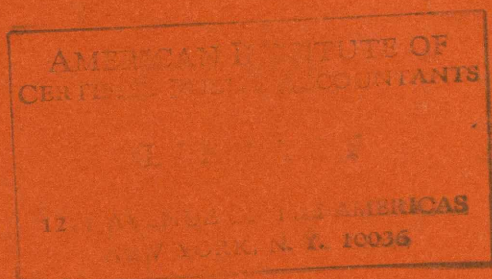
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USA

The Buy/Sell Decision

Small and Growing Businesses



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The Buy/Sell Decision

Small and Growing Businesses

Foreword

Hundreds of thousands of owners of small and growing companies across the country can't be wrong! If you are that unique individual who is motivated by personal accomplishment and stimulated by challenge, whose enthusiasm knows no bounds, who finds it difficult working for "someone else," then you probably are (or want to be) a business owner, an entrepreneur. Many successful owners have started their businesses from "scratch," first conceiving an idea, exploring its feasibility, and then working to bring their idea to fruition. However, in view of the fact that eight out of ten new businesses fail within the first five years, many entrepreneurs turn to the purchase of an existing business in order to reduce the risk of failure.

It is interesting to note that the same desires that motivate buyers (independence, wealth, the flexibility to pursue alternative opportunities) also motivate sellers. While this statement seems strange at first, it becomes easier to understand with the realization that an investment in a closely held business is illiquid in nature and may make the pursuit of alternative personal or financial goals difficult because of the financial and time demands that a business places on its owner.

The purpose of this booklet is to point out ways to help you, the entrepreneur, successfully purchase or sell a closely held company. While exploring the various aspects of a carefully planned deal, you will be shown the common pitfalls that may be encountered and shown ways to avoid them. To assist you in understanding the many considerations bearing upon the purchase or sale of a business, the contents of the booklet have deliberately been kept brief, and so all implications are not discussed. It is therefore important that you consult competent professional advisers at the beginning of, during, and after consummation of any purchase or sale.

If you are an owner who is not currently contemplating the sale of your business, a thorough reading of this booklet should enable you to analyze your company through the eyes of a potential purchaser. This analysis may point out ways to improve the operations of your company as well as to improve its marketability should you desire to sell in the future.

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Introduction

This booklet is designed to provide a systematic framework for evaluating and implementing the purchase or sale of a closely held company. A buyer must first identify which industries should be considered and then evaluate specific companies within that industry that will meet his criteria. Alternatively, a seller must first evaluate his company and industry and then identify a group of potential buyers that will meet his goals. This search and screen process is the first stage of the framework discussed in this booklet.

After a group of serious buyers or sellers has been identified, the method of financing the deal, the tax consequences affecting the structure of the deal, and the valuation of the business must be contemplated simultaneously.

Because of the complexities, the subjects are discussed in individual sections of this booklet.

The final stage of this framework is the negotiation process. This is the critical area in which all of the above-mentioned subjects are brought together to consummate the purchase or sale of the business.

The Buy/Sell Decision

Buy Decision. The process of selecting a business that will fulfill your personal goals can be broken down into the following steps:

- *Identify an industry* or industries that are compatible with your personal objectives and/or expertise.
- *Develop financial and operational screening standards* for evaluating companies within that industry.
- *Identify specific companies* for potential acquisition.
- *Evaluate these companies* using the criteria previously developed.

There are two basic approaches you may take in your *search for prospective industries*. First, look at the industries in which you have business experience. Potential acquisition candidates include present or potential competitors, suppliers, customers, and your employer. You can also examine other industries that have growth potential and in which expertise may be acquired either personally or through use of others having substantial industry experience.

You should match your experiences and strengths with the particular characteristics of the industry under consideration. (Do what you do best.) For example, if you excel at marketing through retail outlets, you

would want to choose an industry where retail distribution is a key factor in success. In this example, you would be cautious about selecting an industry requiring extensive production knowledge unless you feel such management expertise can be hired or acquired in the purchase of the company. If this is the case, the existence of management who will stay on after the purchase becomes an important operational screening criterion.

After determining a suitable industry or industries, *you must develop standards for evaluating specific companies*. These standards, called "screening criteria," cover both financial and operational considerations, and should be considered within the constraints of your acquisition capabilities. For discussion purposes, they are divided into four categories: *financial, marketing, production and management/administration*.

Financial criteria cover sales, profitability, debt structure and cash flow. Sales criteria may be defined in terms of dollars, volume and desired growth. Profitability standards are best expressed as a percentage of sales, total assets or net equity, with additional criteria set for desired growth. Debt structure should be analyzed in terms of the amount of debt to be incurred and the most desirable repayment schedule. Cash flow should be analyzed in terms of both current and future debt service and working-capital needs.

Marketing criteria include desired types of product lines, promotion method, customers, geographic area and distribution channels. These criteria will have already been considered in the industry-selection process; however, they will now need to be defined more specifically. Personal desires and expertise will again play a major role in determining these criteria.

Production criteria must be developed for the type of facilities, labor supply, production techniques, capacity and technology. Criteria in this area are very dependent on the buyer's assessment of the future direction of the industry and growth potential.

Management/administration criteria include specifying needed expertise in company management and personnel, assessment of your personal leadership style, and the receptiveness of existing management to change.

After developing all of the above, determine which ones are the most important. Realize that no one company will meet all the criteria, and only by having a clear idea of which criteria are the most critical will you have a chance of selecting the "best" business.

Your next step is to *identify acquisition candidates*. Many sources can be used to discover prospective companies. Among the most accessible sources are your business associates, accountants, lawyers, bankers; they may have extensive contact with businesses that could meet your criteria. Also, information about competitors, suppliers or customers that could be potential acquisitions can be obtained from trade-association meetings or personnel within your own organization who have contact with such businesses. Finally, the services of an investment broker or an intermediary can be used to identify desirable businesses.

During the process of selecting specific companies, be careful to choose only those companies where a potential for acquisition exists. Some owners will openly be searching for a buyer for their businesses; however, others may not admit that they are considering such a move. In the latter cases, there are two ways in which you can determine if there is any potential for a deal. First, examine the financial position of the company. Financial problems such as cash shortages or excessive debt may indicate that a sale will be necessary to get out of trouble. On the other hand, a very profitable business may be a potential candidate if the owner is looking for a way to get cash out of the business at favorable tax rates.

The second way to determine acquisition potential is to analyze the company's management. Indications of a possible future sale include an owner nearing retirement with no heirs in key management positions, the recent death of the owner whose spouse is not involved in the business, or the existence of absentee owners or owners with conflicting objectives.

After you have initially listed potential candidates, *evaluate them* in light of the screening criteria previously established. This will entail a detailed examination of the businesses in each of the four categories: *financial, marketing, production, and management*.

In the *financial* area, you will want to look at several years of historical data, focusing on sales growth, profitability trends, debt levels and structure, and cash needs. Special effort should be made to determine the causes of historical trends and to extrapolate future trends.

Marketing information should be obtained concerning product lines and mix, customer concentration and mix, principal competitors, patents, trademarks, marketing strategies and distribution methods.

Production analysis includes analysis of technology, capacity, physical premises, labor agreements, production backlog and concentration of suppliers. Finally, information is needed on the reputation of *management*, areas of expertise of key employees, their leadership styles, and degree of dependency on any one member of the management team.

Your accountant and attorney should be used in obtaining and evaluating the above information about specific companies. Your accountant should perform a prepurchase audit to determine the realizability of assets and to determine that all known liabilities are recorded. Ordinarily, this is combined with a "businessman's review" which analyzes the above-mentioned areas. Your accountant should also be requested to put the earnings of several companies on a comparable basis by examining the underlying methods used to determine earnings and preparing "comparable earnings" analyses. Your accountant may also assist in preparing financial forecasts and projections, including assistance in developing assumptions on which to base the forecasts and projections. Your attorney should be used to determine the existence of lawsuits or potential legal liabilities and examine existing contracts, leases, titles and other documents. The attorney will also consult with you and your other advisers to determine the legal form of the transaction. Both accountants and attorneys should be able to pinpoint potential tax benefits or problems with a specific acquisition structure.

The process of selecting a specific business to acquire is rarely easy or clear-cut. However, the process can be greatly simplified by establishing desired criteria for an acquisition and obtaining sufficient information about each company to make a realistic evaluation in light of those criteria. This process will not guarantee that a mismatch or a mistake will not be made; however, it greatly reduces the chance of such an event occurring.

Sell Decision. The preceding section dealt with the decisions and processes a potential buyer faces. Now let us turn our attention to the seller. Briefly, you should *analyze your personal objectives*, *analyze your current operations*, and *identify potential buyers*. Let's begin by looking at some of the seller's typical motivations.

Before you place the business on the market and enter into the negotiating stages, *personal objectives* must be realistically examined. If your objectives do not clearly dictate selling the business, don't waste the time and effort of potential buyers, which might result in a tainted reputation, ultimately discouraging a future buyer. On the other hand, selling your business, or a part of your business, may be a key step in attaining personal objectives.

It is important to remember that each potential seller may have a different set of objectives which will make each sale unique. Additionally, you as a seller may have strong emotional feelings about the business. After specific objectives are analyzed and your emotions say "go," the decision to sell has been made.

Once you've decided to sell, the questions of when to sell and for how much must be answered. The best time to sell is when your business is "at its peak." This places you the seller in a position with the most bargaining power and an ability to sell your business for its full fair market value, maybe more. Your business may be at its peak when its operations become too large to manage personally, you are unable to provide needed capital, the company has achieved its optimum market share, etc.

Before you begin the search for a potential buyer, *analyze the company and its current state of operations*. Know the company and its value. Know its strengths and weaknesses. Be prepared. This will allow for more effective and influential negotiations.

The company should be analyzed in terms of each of the various functional areas described previously. In the marketing area, examine current and potential market share, product strengths and weaknesses, marketing distribution channels, future pricing strategies, industrial trends, competition and possible future technological changes. In production, analyze product costs (raw materials, labor and overhead), availability of materials, product lines and related volume, operational forecasts, manufacturing facilities, and research and development abilities. Management must be analyzed for determination of future personnel requirements, current levels of talent and expertise, and transferability of skills. Finally, analyses in the financial area include estimating the company's future capital requirements through the use of cash forecasts and analyzing profitability using breakeven and ratio analyses.

At the same time you are analyzing, start to *search for potential buyers*.

It is advisable to maintain a file of prospective buyers you have been in contact with over the years. This facilitates the identification of potential buyers when sale is pursued. In addition to personal contacts, other sources of potential buyers include trade associations, investment brokers, and your bankers, accountants, and lawyers.

After you've identified potential buyers, determine which ones are financially capable of purchasing your business. Again, use your business contacts, credit bureaus and trade journals to rule out buyers who can't afford your asking price. Next, determine which prospects are most likely to be interested in your company. Look at your business from each of the prospective buyers' standpoints, and figure out *why* each one should be interested in your business. While you're doing this, realize that a "synergistic" relationship may result in a higher asking price for your company. "Synergy" in this context means that your business will contribute far more to the operations of the buyer than its asking price would indicate. It's the element that makes the equation $2 + 2 = 5$ a perceived reality.

Another consideration in selecting a potential buyer is the reasoning of the purchaser. *The highest bidder is not necessarily the best choice of buyers.* Investigate changes the buyer may be likely to make. For example, will he retain employees, continue present company policies and procedures, continue contracts currently in force, and perpetuate the business?

In any event, seek the advice of both an accountant and a lawyer before any serious negotiations get under way. Your accountant and lawyer can aid in structuring the sale and highlight key areas of negotiation. Your accountant can aid in the analysis of your business's current operations through a businessman's review. This review may also be made of your prospective buyer, to determine financial strength, reputation and capability of going through with the deal. Also, accountants can help in the preparation of your selling plan and its presentation to potential buyers.

In summary, the sell decision follows a set of processes, the first being a defining of personal goals and objectives. Next, understand your company and determine its potential value to a buyer. Prepare yourself for the negotiation stages. And finally, choose the buyer whose business and goals are most compatible with your own. This allows both parties to negotiate more easily a deal that is mutually satisfactory.

Financing

The possibilities for financing a business acquisition are limited only by the creativity of buyer and seller and their advisers. Although even a summary of commonly used financing vehicles is beyond the scope of this booklet, you as either a buyer or seller may be interested in a few creative methods to illustrate that a deal, if otherwise attractive, does not have to be left undone for lack of cash. The three categories of "creative" financing are seller financing, institutional financing and "bootstrap acquisitions" (which in fact are not really financing at all!).

Seller financing commonly takes the form of an instalment sale. A willing seller may be persuaded to accept a small down payment and a schedule of future payments, which could be made from cash generated by operations, in exchange for a higher purchase price or other "kickers" thrown into the deal. Many companies have been purchased for literally no cash at all under this common form of financing!

Institutional financing is especially attractive when real estate or equipment comprise a major portion of the purchased assets. Depending on location and condition of real estate and equipment, institutions custom-

arily loan up to 80 percent of appraised value over periods as long as thirty years. The required "down payment" may be decreased even more if the buyer holds personal collateral which can be used to obtain personal financing of the down payment. As with any transaction, however, the greater the leverage, the greater the risk.

A popular form of transaction which utilizes both seller and institutional financing is the *leveraged buyout*. In this transaction, a bank or other financial institution may lend up to 90 percent of the purchase price in exchange for favorable payment terms offered by the seller, the involvement of key members of management as purchasers, and the ability to convert all or a portion of the funds advanced to an ownership interest in the company at some future date.

Bootstrap Acquisitions

The bootstrap sale of a corporation entails using the corporation's funds to "purchase itself." The business, in effect, uses either its future earnings or its present assets to purchase itself. In a bootstrap acquisition the seller will draw a large quantity of cash out of the corporation by having the corporation redeem most of his shares. Following the redemption, the corporation will have a lower market value and lower earnings and profits; the buyer will find the corporation more affordable (he is buying fewer shares of stock) and more attractive, as he is buying a corporation with little or no earnings and profits, and thus avoid in the future dividend or accumulated-earnings tax problems. If the redemption and the sale are properly handled, both parties should achieve their goals. The seller will be taxed at favorable capital-gain rates on the redemption and the sale, and the buyer will obtain the corporation at a lower price.

The above are just a few examples used to demonstrate that purchasing a business does not necessarily require large amounts of capital. The exact form of financing your transaction will depend on the desires of both buyer and seller, and should be determined only after extensive consultations with your banker, tax adviser and attorney.

Tax Implications (of Taxable Transactions)

A major consideration in the purchase or sale of a business is the effect on the tax liability of both buyer and seller. Let's examine the fundamental pros and cons of a business acquisition from the tax viewpoint of buyers and sellers.

The acquisition or disposition of a business may be structured under one of two basic formats:

- The buyer can purchase the seller's stock.
- The buyer can purchase part of or all of the seller's assets.

Although these forms are treated somewhat the same for financial reporting purposes, tax consequences can vary significantly. The "best" form of a particular transaction will depend on the facts and circumstances of each case. Often, the tax consequences will dictate the form of the transaction and are a major part of the negotiated package. This section discusses the basic tax implications of each type of transaction, presents typical ways in which each type of transaction may be structured, and discusses certain other considerations every buyer or seller should be aware of. Since the tax implications of acquiring or disposing of a business are very complex, and a poorly structured transaction can be disastrous, competent tax advice should be sought as early as possible.

Sale of Stock. Seller's Considerations. Generally, you as a seller will prefer the sale of stock to the sale of assets. The tax implications of a stock sale are simpler, and the gain, with notable exceptions discussed below, is usually a capital gain, which, for individuals, means that only 40 percent of the gain is subject to federal income taxes. But perhaps more important, the seller dissociates himself from the business, including its contingent liabilities, in a stock sale, unless the contract states otherwise.

The starting point for the seller of stock is the determination of his *tax basis*. Taxable gain or loss on the sale is the difference between the amount realized on the sale and the tax basis in the stock. Generally, the tax basis of stock is its purchase price, that is, the value in cash or other property paid to obtain the stock.

Generally, any gain or loss on the sale of stock will be capital gain or loss, with some exceptions:

- If the stock is tainted "section 306" stock (which generally would have resulted from a previous corporate reorganization), ordinary income could result.
- If the stock qualifies as "small business stock," \$50,000 (\$100,000 on a joint return) would be treated as ordinary loss, while a gain would receive favorable capital-gain treatment. This "dual treatment" is very advantageous to a seller.
- If the stock is redeemed by the corporation, dividend (ordinary) income could result.

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- If interest is “imputed” (discussed later), favorable long-term capital gain could be called interest income (subject to ordinary-income rates) by the IRS.
 - If the consideration received is for other than the transfer of stock (such as for the rendering of services or a covenant not to compete), ordinary income may result.

Buyer's Considerations. An individual who purchases corporate stock becomes the “owner” of the acquired corporation so that the corporation continues in existence under new control. The buyer's tax basis in a cash purchase of stock is the cost of the stock, including costs associated with acquiring the stock (broker's fees). The purchase of stock in no way affects the basis of assets held by the corporation, and therefore asset values cannot generally be increased to allow for higher future depreciation, amortization and other deductions. However, a buyer that is a corporation may be able to get this “step-up” in value under section 334(b)(2) of the Internal Revenue Code.

In a *section 334(b)(2) transaction*, if the buyer's tax basis in the stock is greater than the corporation's tax basis in its assets, and the fair value of the tangible assets is greater than the corporation's tax basis, the buyer can obtain a step-up in the tax basis of the newly acquired corporation's assets, which allows for higher future depreciation deductions, by liquidating the purchased corporation in a section 334(b)(2) transaction. To obtain this step-up the buyer must be a corporation.

In this type of a transaction, tax benefits that have been reaped in the past may have to be repaid by the seller (recapture). However, these benefits will be allocated to the assets received and will further increase the buyer's basis in those assets. Additionally, the tax identity of the liquidated corporation will be lost, resulting in the loss of any available net operating losses, capital loss carryovers, or tax credits. The potential advantages to the buyer in a section 334(b)(2) liquidation, e.g., greater depreciation deductions, etc., must be weighed against the various disadvantages such as recapture and loss of carryovers to determine whether such a liquidation is beneficial.

Sale of Assets. Seller's Considerations. In a taxable sale of corporate assets, the corporation can either:

- sell the assets, liquidate and distribute the proceeds to the original shareholders, or, as occurs less frequently,
- liquidate and distribute the assets to the original shareholders and allow the shareholders to negotiate their own sale with the buyer.

Each possibility poses different planning considerations. In short, the seller's tax concerns in an asset sale (especially a sale involving a gain) depend upon what the corporation intends to do with the sale proceeds. Also, since the corporation itself continues after the sale of assets, contingent liabilities of the business remain the seller's responsibility.

If the corporation plans to sell its assets and distribute the proceeds to its shareholders in complete liquidation, the formalities of the procedures and the timing of the events must be carefully scheduled. If required procedures are followed, the corporation will recognize no gain or loss (except on inventory sold other than at a bulk sale, recapture of tax benefits, depreciation, etc., and disposition of instalment obligations), and the shareholders will treat the property received as an exchange for their stock. Note that for years after *December 31, 1981* the "LIFO reserve," if any, will be recaptured and taxed to the corporation. The shareholders will generally have capital gain or loss. For a liquidation to withstand scrutiny, a plan of liquidation must be adopted by the board of directors and approved by the shareholders prior to the sale.

Allocation of Purchase Price to Individual Assets. Once a purchase price has been negotiated in total, you should agree on an allocation of the purchase price to the various individual assets. In this regard, the positions of the buyer and the seller are generally in opposition. The buyer of assets wants to allocate as much as possible to depreciable and amortizable assets which will produce future tax benefits, while the seller wishes to reduce ordinary-income treatment by allocating the purchase price to "capital assets" (such as goodwill) if possible.

The allocation of the purchase price to individual assets is generally the result of the negotiating process. The importance of allocating costs to specific assets before coming to final agreement on the sales contract cannot be underestimated. A unilateral allocation by one of the parties after the sale may not be acceptable. If the purchase price is not allocated to individual assets, both parties could conceivably lose, as they might be forced to negotiate an allocation agreement with the IRS.

Another negotiating point revolves around "*covenants not to compete*" versus "*goodwill*." A *covenant not to compete* will result in ordinary-income treatment for the seller, while the buyer will generally be able to deduct the value of the covenant over its useful life. *Goodwill*, on the other hand, is not deductible because its useful life is indeterminate. In spite of this, *goodwill* is a capital asset, and its sale will produce capital gain or loss to the seller. Consequently, the buyer will prefer a *covenant not to compete*, while the seller will prefer to allocate a portion of the sales price to *goodwill*.

When a depreciable asset is sold at a gain, any depreciation taken after 1961 on personal property may be *recaptured* as ordinary income. Investment tax credit taken on the asset may also be recaptured.

Buyer's Considerations. As discussed above, the *allocation of the purchase price* to individual assets is equally important to buyers. Furthermore, the buyer should determine which of the assets are eligible for investment credit and which are eligible for bonus depreciation in the year of acquisition. Although both are subject to limitations, these allowances can help "finance" the purchase.

The corporation's tax identity will not follow its assets. Therefore, in a purchase of assets, *the buyer does not obtain any net-operating-loss carryovers, capital-loss carryovers, etc.* The buyer is not bound by the selling corporation's accounting methods and is free to employ his own accounting methods, subject to the general limitations of the law.

Other Considerations. *The Installment Sales Revision Act*, which is effective for sales made in 1980, makes the instalment method of purchasing a business even more attractive than before. As discussed under "FINANCING," previously, the buyer pays for a business over a period of years; the seller reports any gain only when payment is received from the buyer.

Imputed interest may result if a deferred-payment contract arising from an instalment sale does not provide for a reasonable rate of interest. The IRS will hold that a portion of future payments represents interest income (rather than a more favorable capital gain) to the seller, and will compute this interest at a statutory rate.

In conclusion, the tax implications of acquiring or disposing of a business are extremely complex. This discussion was not intended to be all-inclusive or to explain major implications in depth, but merely to acquaint potential buyers or sellers with major factors they should consider when negotiating. It is imperative that anyone considering purchase or sale of a business obtain competent tax advice from an accountant or attorney in order to avoid the disastrous results that could occur if the transaction is improperly consummated.

Valuing the Business

After deciding that you may want to buy or sell a business, the subject of "how much" becomes important. Pricing a business is one of the most difficult aspects of any deal, since every business is different. In establishing a price, you should recognize that buyer and seller are involved in making an investment decision. This decision must comprehend the al-

ternative sources and uses of funds, which can have a strong impact on the final price, as will be illustrated later.

This section describes some of the methods that are used in valuing a company and illustrates with the use of a simple example how these different methods can give widely different results. Although a buyer or seller has an unlimited variety of methods to value a particular company, the following pages present some of those commonly used. The ultimate price of a business will actually be set through buyer/seller negotiation, usually based upon one or more valuation methods.

Two approaches are commonly used in evaluating a closely held business. The first approach uses the balance sheet to arrive at fair value of net assets. The second approach analyzes the future income or earnings potential of the company. Each approach has several alternative methods, and each approach has advantages and disadvantages. The balance-sheet methods are generally less reliant on estimates and forecasts than the earnings methods. However, the balance-sheet methods totally ignore the future earnings capabilities of a company.

The earnings methods are based on future earnings potential. The major disadvantage of these methods is that their approach relies heavily on estimation and forecasts and therefore on the ability of the estimator or forecaster.

Balance Sheet Methods. *Book value* is probably the easiest method to use. You simply take the total assets as shown in the financial statements and subtract total liabilities. The advantage of this method is that the numbers are readily available. Its drawbacks are numerous. The company's accounting practices will have a big impact on its book value. Book value does not reflect the fair market value of assets and liabilities. The fair value of patents, trademarks, and the like may not be expressed, and book value ignores earnings potential. Despite these drawbacks, book value may be useful in establishing a point of reference when considering asset valuation.

Adjusted book value is simply the book value adjusted for major differences between the stated book value and the fair market value of the company's fixed assets and liabilities. This is obviously a refinement over the plain book value but still has many of the same drawbacks. The adjusted book value does give a more accurate representation of the value of a company's assets than does book value.

Liquidation value estimates the cash remaining after the company has sold all of its assets and paid off all of its liabilities. This method assumes that a bulk sale takes place, and therefore many of the prices one would

get for the assets are lower than "fair market value." Although this method is meaningful for determining a price only if a liquidation is anticipated, financial institutions commonly use this method to determine the value of assets used as collateral to secure financing.

Earnings Methods. In using the following methods, "earnings" may be arrived at in one of three ways.

- Use an average of the past three to five years' income as an estimate of future annual earnings.
- Use an estimate of future earnings under the current owners' management, adjusting for inflation and industry trends.
- Use an estimate of future earnings under the new owners' management, adjusting for inflation and industry trends.

Of these methods, the last one is probably most useful to the buyer. The major disadvantage of using average historical income is that past conditions may not remain the same in the future. As we are all aware, business conditions are constantly changing. In order to be successful, one has to anticipate and plan for these changes. In order to establish a reasonable estimate of future earnings potential, known and anticipated changes must be adjusted for.

The first method assumes that historical earnings will remain essentially unchanged, and therefore is a valid indicator of future performance.

The second method of defining future earnings assumes that past management is successful, and that this management will continue to operate the company after the sale.

The third method analyzes the effect that new management will have on future earnings. These effects include changes in marketing strategy, manufacturing technology, and management philosophy. Another adjustment typically made is the add-back of business-related expenses of a personal nature (for example, the owner's company car or country-club membership). These types of expenses should be added back whether or not the buyer anticipates having the same types of expenses, since they are actually a return on investment for the owner. While this reasoning is advantageous to the seller who wants to show the "true" value of his business, the buyer should be alert to the fact that the IRS may later challenge these personal expenses, which could result in an unanticipated liability for additional taxes.

For the seller, add-back of such expenses increases the earnings upon which the sales price will be set. For the buyer, these add-backs present a more realistic picture of the company's earning power.

Once earnings have been defined, various approaches are used to price future earnings power. Three of the more common approaches are *capitalized earnings*, *discounted future earnings*, and *discounted cash flow*.

Capitalized earnings are defined as average aftertax earnings over a specified period, divided by initial investment. In using this approach for valuing a company one first sets a *desired rate of return*. The initial investment or value is then computed as the average aftertax earnings divided by the desired rate of return. The advantage of this approach is that it is easy to use. The major disadvantage is that the value of the company can be grossly overestimated because this approach does not take into account the time value of money which recognizes that a dollar received today is worth more than a dollar received in the future.

The *discounted future earnings* approach initially requires estimation of aftertax earnings for future years (generally five to ten years) and the investor's desired rate of return. Each year's earnings are then discounted (the process of dividing sums to be received in the future by an assumed earnings rate) by the desired rate of return. The sum of these discounted values is the estimated value (present value) of the company. The assumptions used to estimate aftertax earnings for future years are generally subject to some negotiation between the buyer and seller before a final valuation is reached.

The inherent advantage of this approach is that future earnings potential becomes the investment criterion, taking into account the time value of money. Disadvantages include the fact that, like any estimate, future earnings cannot be projected with certainty. In some cases there may be a large element of uncertainty. And, it may not be possible to reinvest all earnings because of practical limitations imposed by the business environment and because earnings do not necessarily take the form of "cash."

The first disadvantage can be overcome to some extent by separately considering optimistic, pessimistic and most-likely outcomes for future earnings. The second disadvantage can be overcome by using the following method.

The *discounted cash flow* approach is essentially the same as *discounted future earnings*, except that cash flows rather than earnings are projected for each future year.

No single approach is perfect, and there are limitations with the *discounted cash flow* approach as well. Like all of the other earnings approaches, it depends upon estimates and assumptions, which carry a large degree of uncertainty. Generally speaking, however, this method and the *discounted future earnings* approaches, when used prudently, can overcome these disadvantages to provide reasonable estimates of a company's value.

The following simplified example of the Elpmaxe Co. will illustrate the methods discussed above. The following assumptions are reflected in the computations.

- Future earnings are estimated under new management's philosophy. In your own situation, this approach may require adjustment of several variables.
- Earnings will grow at a rate of 20 percent per year.
- The company records inventory at its LIFO cost, which does not represent its current value.
- The income tax rate, including state and local income taxes, is 50 percent.
- The desired return on investment is 15 percent.

EXHIBIT A**ELPMAXE CO.****Balance Sheet
December 31, 19X0**

	<u>12/31/X0</u> <u>(in 000s)</u>		<u>12/31/X0</u>
Current Assets	\$3,380	Current Liabilities	<u>\$1,990</u>
Fixed Assets	3,670	Long-Term Debt	<u>3,055</u>
		Total Liabilities	5,045
		Stockholders' Equity	<u>2,005</u>
		Total Liabilities and Stockholders' Equity	<u>\$7,050</u>
Total Assets	<u>\$7,050</u>		

EXHIBIT B

ELPMAXE CO.**Statement of Income**
December 31, 19X0

	<u>12/31/X0</u> <u>(in 000s)</u>
Sales	\$20,000
Less—Operating expenses	<u>18,500</u>
Earnings Before Taxes	1,500
Less—Taxes (.50)	<u>750</u>
Earnings After Taxes	<u>\$ 750</u>
Summary of Earnings for Last Four Years:	
Earnings after taxes for year ending:	
December 31, 19W9	<u>675</u>
December 31, 19W8	<u>607</u>
December 31, 19W7	<u>547</u>
December 31, 19W6	<u>492</u>

ELPMAXE CO.**Projected Five-Year Earnings and Cash Flow**

<u>Year</u>	<u>Earnings After Taxes (in 000s)</u>	<u>Cash Flows (in 000s)</u>
19X1	\$1,350	\$ 779
19X2	1,620	935
19X3	1,944	1,122
19X4	2,333	1,346
19X5	2,799	1,615

ASSUMPTIONS:

1. Earnings and cash flows were adjusted by adding back personal expenses of owner.
2. Earnings and cash flows grow at a rate of 20% per year.

NOTE: In an actual buy/sell situation, one should make growth projections for sales, operating expenses, capital expenditures, etc., separately rather than simply projecting a growth rate for earnings and cash flows alone.

ELPMAXE CO.**Methods of Valuation
"Balance-Sheet" Methods**

	<u>(000s)</u>
I. Net Book Value	
Total Stockholders' Equity (represents assets net of liabilities) (Exhibit A)	<u>\$ 2,005</u>
II. Adjusted Net Book Value	
Net Book Value (above)	\$ 2,005
Plus:	
Excess of appraised replacement value over book value of fixed assets (Note 1)	3,330
LIFO reserve (Note 2)	500
Value of patents not on books	<u>50</u>
Adjusted Net Book Value	<u>\$ 5,885</u>
III. Liquidation Value	
Net Book Value (above)	\$ 2,005
Plus:	
Excess of appraised liquidation value over book value of fixed assets (Note 3)	2,430
Less:	
Deficit of appraised liquidation value over book value of inventory (Note 3)	(100)
Income taxes due upon liquidation (Note 4)	<u>(1,165)</u>
Liquidation Value	<u>\$ 3,170</u>

NOTES:

1. Appraiser's opinion of cost to purchase assets of similar age and condition at their present retail value.
2. Inventories are carried at LIFO value, which is below their current cost. The present owners adopted LIFO in order to reduce income taxes.
3. Appraiser's opinion of value if fixed assets and inventory were to be sold in bulk at a forced sale.
4. Represents income taxes to be paid if assets and liabilities were liquidated according to the above values.

EXHIBIT E**ELPMAXE CO.****Methods of Valuation
"Earnings" Methods****I. Capitalized Earnings**

Average Earnings Over Past Five Years (Exhibit B):	
19W6	\$ 492
19W7	\$ 547
19W8	\$ 607
19W9	\$ 675
19X0	<u>\$ 750</u>
Total	<u>\$3,071</u>
	÷ 5
Average Earnings	\$ 614
Divided by Investor's Desired Rate of Return (Note 1)	15%
Result — Value of Company Based on Accounting Rate of Return	<u>\$4,093</u>

II. Discounted Future Earnings

	(1)	(2)	(3)
<i>Future Year</i>	<i>Aftertax Earnings (Exhibit C)</i>	<i>Present Value Factor—Assuming 15% Return (Note 1)</i>	<i>Present Value of Aftertax Earnings (1) × (2)</i>
19X1	\$ 1,350	$\frac{1}{(1.15)^1} = .870$	\$1,174
19X2	1,620	$\frac{1}{(1.15)^2} = .756$	1,225
19X3	1,944	$\frac{1}{(1.15)^3} = .657$	1,277
19X4	2,333	$\frac{1}{(1.15)^4} = .572$	1,334
19X5	<u>2,799</u>	$\frac{1}{(1.15)^5} = .497$	<u>1,391</u>
Total	<u>\$10,046</u>		<u>\$6,401</u>

The value of ELPMAXE CO. under this method is \$6,401,000.

III. Discounted Cash Flow

<i>Future Year</i>	(1) <i>Estimated Cash Flow (Exhibit C)</i>	(2) <i>Present Value Factor—Assuming 15% Return (Note 1)</i>	(3) <i>Present Value of Cash Flow (1) × (2)</i>
19X1	\$ 779	$\frac{1}{(1.15)^1} = .870$	\$ 678
19X2	935	$\frac{1}{(1.15)^2} = .756$	707
19X3	1,122	$\frac{1}{(1.15)^3} = .657$	737
19X4	1,346	$\frac{1}{(1.15)^4} = .572$	770
19X5	<u>1,615</u>	$\frac{1}{(1.15)^5} = .497$	<u>803</u>
Total	<u>\$5,797</u>		<u>\$3,695</u>

The value of ELPMAXE CO. under this method is \$3,695,000.

NOTES:

1. The actual return an investor will use depends upon his cost of capital, as well as the perceived risk inherent in a particular investment. The riskier an investment is, the higher the return should be.
 2. All three of these methods ignore "terminal value," i.e., the value of the company at the end of five years. Whether terminal value is taken into account depends upon facts and circumstances applicable to the particular transaction under analysis.
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EXHIBIT F

ELPMAXE CO.**Summary of Results**

	<u>(000s)</u>
Net Book Value (Exhibit D)	<u>\$2,005</u>
Adjusted Net Book Value (Exhibit D)	<u>\$5,885</u>
Liquidation Value (Exhibit D)	<u>\$3,170</u>
Capitalized Earnings (Exhibit E)	<u>\$4,093</u>
Discounted Future Earnings (Exhibit E)	<u>\$6,401</u>
Discounted Cash Flow (Exhibit E)	<u>\$3,695</u>

As demonstrated, the values of Elpmaxe Co. vary widely, depending upon the method used. The actual value of Elpmaxe Co. depends upon which method is the most appropriate. The seller should argue that capitalized earnings (yielding the highest value) is the most appropriate method. While the buyer could argue that net book value is the most relevant, the difference between net book value and any of the "earnings" values is so great that one must objectively conclude that the net book value of the company is irrelevant. The buyer would therefore argue that one of the other methods, yielding a lower value than capitalized earnings, is most relevant.

After making the computations discussed on the preceding pages, a few additional valuations should be considered. If information on sales of companies in the industry can be obtained (talk to your accountant, lawyer, broker or intermediary), several comparisons can prove to be meaningful.

Price/earnings ratios (the price of a company divided by aftertax earnings) are useful in determining the price investors are willing to pay for the earnings power of companies in the industry. A major advantage of using price/earnings rates (P/E) is that these figures are readily available for publicly held companies in the industry—just pick up the stock-market section of your daily newspaper. Although P/E's for publicly traded companies are not comparable with ratios computed for closely held businesses because of the inherent differences in the two types of entities, such a comparison may provide an accessible reference point from which to value your company.

Price/book-value ratios (the price of a company divided by its book value) indicates the premium investors have paid for companies in the industry. While these statistics are usually not readily available for closely held companies, they are easily computed for publicly held companies using information available to the general public. These ratios may then be used in providing a reference point for valuing your company.

The purpose of this chapter was to illustrate the range of possible values for a single business. You as the buyer or seller choose the method (or a combination of methods) that supports your price. After choosing your price, list the reasons why your method produces the best results and provide logical support for these reasons. Now you are ready to enter the phase at which price will actually be determined, the negotiations.

Negotiation

Negotiation is a delicate, crucial, and often frustrating part of a purchase/sale because the buyer and seller have conflicting goals; each participant wants to get the most for what each has to offer. However, it is at this point that the seller of a business may have the advantage. It is the seller who knows exactly what he is selling and exactly what he wants to receive. The buyer is left with an element of the unknown no matter how thorough his inquiries may have been. Therefore, *caveat emptor* should be the rule in any serious negotiations . . . "let the buyer beware."

In making the initial contact with a prospective buyer or seller there are some general guidelines to be followed. These are preliminary steps that should be taken before any serious discussions regarding the culmination of a transaction are held.

- *Understand the business.* The seller may already assume that he has adequate knowledge of his business to enter into negotiation. However, a review of the business's key operational areas by both buyer and seller will allow discussions to proceed in an orderly fashion. An outline of the business's finances, its management and its overall viability in the marketplace can be a starting point in attaining an assessment of the business on which both parties can agree.
- *Seek professional help.* Professional advice of accountants, attorneys and investment bankers experienced in acquisitions can help to insure that a satisfactory agreement will be reached. Their experience will be helpful not only in the subtleties of the closing, but in the valuation as well. However, all professionals should be expected to provide references. An individual or intermediary whose compensation is contingent on culminating the deal is of no value to the buyer or seller.
- *Evaluate the other person.* Before any detailed strategy is outlined for negotiations there should be some understanding of the other participant's point of view. Strategies can vary depending upon an owner's reasons for selling or a buyer's reasons for purchasing. For example, an owner interested in raising capital for another venture will most likely have different interests in terms of the structure of the deal than an owner wishing to retire. An initial meeting to discuss each other's expectations, without arguing over specific details, could go a long way to initiate the preparation of an attractive offer.

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- *Assess your strengths and weaknesses.* Developing an effective strategy requires not only knowing the other person's position, but knowing your own position as well. An outline of the strengths and weaknesses of your position should be prepared before any negotiations take place. Professional advice concerning exploitation of your strengths and defense of your weaknesses will help to give you an adequate backup for any discussions that may arise.
 - *Be realistic.* Negotiation, by definition, is the mutual discussion of the terms of a transaction or agreement. In discussing the formation of a mutually satisfactory arrangement there will undoubtedly be conflicts. If you realize that these conflicts are inherent parts of the negotiation process, then the negotiations will proceed with a minimum amount of frustration.

Before critical negotiations, you should properly develop a *negotiating plan* that is commensurate with your goals and objectives. The key is to prepare yourself; this includes having a backup position for any statement or offer you make that may be contested or flatout rejected. Maneuver the inevitable arguments to support your position. Along these lines, *before* you're backed into a corner, shift the burden onto the other party's shoulders.

Just as arguments are inevitable, so are demands that will *seem* non-negotiable to you. When this arises, test the other party to see if the demand is sincere. This can be done by changing the discussion to an area where no reasonable person would disagree. If you still disagree when returning to the "nonnegotiable" point, the other party's demand may be sincere and you may want to withdraw from further negotiations. Then again, this may be an ideal situation for a strategic trade-off. You could give in on this particular demand to gain (at present or further into the negotiations) a point that is of significant importance to you.

Below are some suggestions for the buyer and the seller respectively. It should be noted that one of the most critical steps in buying or selling your company is to be able to look at it from the perspective of the other side. Both the buyer and seller should sell themselves as legitimate parties interested in the buy/sell decision at hand. It's important not just to hear but to truly understand what the other party is saying. This will eliminate a lot of fruitless discussion and wasted time.

Suggestions for the Buyer. At the time of the initial contact, at all costs, avoid the cheapest deal. You should be looking for the best total transaction. Agree on general limits of the price and the structure of the deal, but avoid initial conflicts relating to any details pertaining to these areas.

You may consider stating that:

- Sales projections are too high because of, e.g., management's departure or nepotism in the field.
- Production costs are too low because of inflation or startup costs.
- Marketing costs are too low since you must spend more to maintain sales or clients.
- Risks of a "new" venture are great.
- Debt servicing of purchase price is significant.

Suggestions for the Seller. At the initial contact, you as the seller should be satisfied with your asking price. With the exception of materially relevant information, don't represent what is not asked. Most important, consider several potential buyers. This may result in obtaining a higher price than originally considered, and the transaction should more closely follow your terms.

You may consider stating that:

- Sales are low because you haven't attempted to expand (if this is a true statement).
- Production costs are adjusted for inflation, and the product is price elastic.
- Administrative costs are inflated because, e.g., personal expenses have been run through the business, family members are employed.
- Risk is negligible in an established business.
- Debt may be readily obtained because of high value of building and equipment.

When it comes time to close the deal, the buyer should review and confirm (through an audit or other means) all pertinent information. Now you're ready for the contract. Although your attorney should be involved early on in negotiations and can advise you of key contract provisions, all contracts should include:

- Contract price and payment terms
- A definition of what is being sold (e.g., "all of the outstanding stock," "net assets")
- A list of liabilities to be assumed by the buyer

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- Seller's warranties
 - Seller's obligations prior to closing
 - Conditions that are the buyer's obligations at the time when buyer assumes risk of loss
 - A covenant not to compete

The contract should also provide that a lien and title search be conducted to determine that ownership of assets and related liens is as represented by the seller.

In closing, look for a "synergistic transaction"; that's one in which the total is greater than the sum of all the individual company parts or individual's goals and objectives.

Don't forget to "rehearse" your part in the negotiations. Finally, don't make a deal that favors only you. This type of deal causes animosity and may end up in court.

Conclusion

The successful purchase or sale of a small business starts with an analysis of your personal goals and objectives, and continues with the design of a deal designed to fulfill them. After careful planning and analysis, including valuation of your business, find the right buyer or seller and begin negotiation. If you've done everything right, the result will be a transaction that satisfies both you and the party sitting on the other side of the negotiating table.

The issues discussed throughout this booklet present but a brief sketch of the successful sale or purchase transaction. As readers of this booklet will typically have little experience in purchase or sale transactions, and since any particular transaction the reader may be contemplating will represent a significant investment of time and money, the importance of sound professional advice cannot be over-emphasized. Advisers such as accountants, attorneys, bankers or intermediaries who have significant experience in these types of transactions should be consulted as early in the process as possible in connection with your analysis of personal goals and objectives. Their advice should be sought frequently during the entire process to assist you in making informed decisions that will achieve the desired results.

How Deloitte Haskins & Sells Can Help *YOU* Buy or Sell a Business.

Our firm is capable of serving you in every stage of the buy/sell process. A brief summary of services customarily provided at each of these stages is as follows:

Buy/Sell Decision

- Provide industry data to assist buyers in selecting potential industries and in evaluating particular companies in light of industry performance.
- Assist buyers in finding companies by determining acquisition criteria and searching our data base of companies being offered for sale.
- Assist sellers in finding buyers by incorporating essential data in our data base.
- Assist seller in maintaining confidentiality by releasing only information a potential buyer needs to know.
- Provide information on the buyer to the seller to aid in seller's assessment of the other party's capability.
- Conduct a "businessman's review" of either buyer or seller to assist sellers in evaluating buyer's capabilities and philosophy, and to assist buyers in making initial assessments of potential acquisition candidates.
- Prepare proforma financial information by placing several acquisition candidates on comparable bases of accounting to assist the buyer in selecting a company.

Financing

- Provide consultation regarding appropriate forms of financing, and assist in determining possible sources of funds.
- Assist in compiling forecasts, projections and other data required by financial institutions prior to loan approval.

Tax Services

- Assist buyers, sellers and their advisers in determining the tax effects of possible forms the transaction might take.
- Assist in securing IRS rulings on questionable aspects of a transaction in order to avoid a possible tax disaster upon subsequent IRS audit.
- Determine statutory requirements of the chosen tax structure, and assist in meeting these requirements.

Valuation

- Compile proforma projections that give effect to buyer/seller assumptions regarding future operations.
- Assist in valuing the company using reports of appraisers, forecasts and projections, and information regarding similar sales in the industry and geographic location under consideration.
- Assess the validity of other party's assertions supporting a particular valuation.
- Conduct a prepurchase audit to determine validity of financial data provided by the seller.

Negotiation

- Consultation regarding development of key negotiating points and possible alternative positions.
- Evaluation of counterproposals to assess their impact on the transaction.

For further information about our small business services, please contact:

- Your nearest Deloitte Haskins & Sells office
- Or write:

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